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No. 84-633

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

EDWARD K. WHEELER,
Petitioner,
v.

INTERSTATE COMMERCE COMMISSION,
UNITED STATES OF AMERICA

and

UNION PACIFIC CORPORATION, *et al.*,
Respondents.

**REPLY BRIEF OF PETITIONER
EDWARD K. WHEELER**

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REPLY ARGUMENT

The issue presented is whether the Interstate Commerce Commission ("ICC") was correct in finding that the offer of the Union Pacific Corporation, through a subsidiary ("UP"), to acquire all outstanding shares of the Western Pacific Railroad Company ("WP") for slightly less than \$28 million is "fair." Petitioner, a minority shareholder of WP, respectfully submits that the Commission's valuation methodology was fatally flawed in that it did not consider the current market value of assets contributed by the WP shareholders to the UP, and thereby deprived the minority shareholders of just and reasonable compensation for the property that was taken from them. Briefly stated, the Commission found that

\$28 million was a fair price to pay for both the WP as an operating railroad and for its non-operating real estate when the real estate alone is currently appraised at approximately \$137 million.

In reviewing this matter, the Court is urged to consider that, unlike the situation in an ordinary merger where the former shareholders receive stock of the new corporation in exchange for their shares in the old company and thus continue to realize the economic benefits derived from the assets they contributed, the WP shareholders are being divested of all future interest in their railroad. Not only is their stock being taken from them on the payment of \$20 per share by UP, but they are barred from further participation in any future earnings of the railroad or profits realized from the sale of the real estate which they are being compelled, over their objection, to sell to UP. Hence, it is essential that they be fairly compensated for their property at this time.

It is Petitioner's position that the ICC's valuation methodology resulted in the ICC approving an offering price that reflects *only* the earning power of the WP,¹ and does not include compensation for WP's non-operating real estate. This real estate is not needed or used in WP's railroad operations and is being sold from time to time by UP. Thus, the ICC has authorized UP to force out all WP shareholders and to obtain at least \$137 million of real estate not used in the WP's railroad operations *free of charge* at the expense of the minority shareholders.

¹ It should be noted that the Commission's methodology initially resulted in the shares being valued at \$67 per share (Pet. App. p. 305a). After discounting the estimated future stock price to present value, the Commission still found the shares to have a present value at time of consummation of \$38 per share (*id.*). It was only after the Commission engaged in yet another unprecedented and improper adjustment that it arrived at a value of only \$20 per share. The validity of this final adjustment is a matter before this Court (84-633 Pet. pp. 13-14, n. 10).

A. The Committee's Methodology Disregarded a Significant Portion of the Value of the WP's Shareholders' Contribution

In responding to Petitioner's claim that "the Commission's methodology disregarded a significant portion of the value of the WP shareholders' contribution to the merged company" (84-633 Pet. p. 2), respondents reiterate the lower court's observation that the Commission did not simply disregard WP's landholdings, but rather "stated that such holdings are relatively unimportant in the context of the [capitalized earnings] methodology the Commission used in determining a reasonable range of prices for WP's stock." (UP Br. p. 13, Fed. Res. Br. pp. 16-17). It is respectfully submitted that this is but an exercise in semantics. Whether the value of the real estate was disregarded or simply considered to be relatively unimportant by the ICC, the ultimate effect on WP stockholders is the same.²

² The Federal Respondents' assertion (Br. p. 17) that "[t]he record clearly indicates that the value of WP's land was reflected in the methodology used by the Commission to determine the stock's going concern value" is specious. This assertion is belied by the fact that the Commission and parties were not aware throughout the proceeding of the actual current appraised value of the land. The actual present value was first revealed in a prospectus distributed to WP stockholders after the record was closed and the Commission had issued its decision. A WP shareholder, following the release of the Commission's decision, requested the Commission to reopen to consider evidence of the estimated value of WP's present land holdings as disclosed in the Notice to Shareholders, dated May 2, 1983. The ICC refused to consider these values and denied the petition.

The Federal Respondents' further attempt to bolster this argument by contending that the market price reflected the value of these lands is of no avail. Where such assets are carried on the corporation's books at a mere fraction of their current value, it is unreasonable to conclude that the market price will take account of such assets. See *Note, Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 Harv. L. Rev. 1453-1457 (1966).

The lower court and the Commission simply failed to appreciate that *Schwabacher*³ does not permit the Commission to adopt a formula that irrationally strips shareholders of the value of the most significant asset they are surrendering. While in some instances a simple application of the capitalization of earnings methodology may be appropriate in determining the value of railroad stock and rail properties such as rights-of-way used by the railroad in its on-going railroad operations, the Commission may not blindly ignore other assets contributed by the shareholders which are of greater value than the railroad. This is particularly true where, as here, the railroad's non-operating assets include extremely valuable real estate that is not used in the railroad's on-going operations but is held for development or future appreciation. Such lands do not contribute to the railroad's earnings except when they are sold. In these circumstances, the capitalization of earnings methodology wholly fails to give appropriate considerations to assets that have greatly appreciated in value.

B. The Commission's Methodology Is an Unexplained Departure From Prior Norms

Respondents have also taken issue with Petitioner's arguments that the Commission's unique analytical approach is an unexplained departure from its prior cases. Relying on the single phrase in *Seaboard Air Line Railroad Co.—Merger—Atlantic Coast Line*, 320 I.C.C. 122, 193 (1963) that "the physical values of the railroad properties are not controlling, for under the *Schwabacher* principle, the predominant factor is the earnings of the properties rather than their values," UP fails to observe that the Commission in *Seaboard* specifically identified "ownership of industrial lands" as an additional factor to be considered in determining proposed stock exchange ratios (*id.* p. 190). Furthermore, in that case appro-

³ *Schwabacher v. United States*, 334 U.S. 182 (1948).

priate adjustments in the stock exchange ratio were made "to reflect the earning capacity of Coast Line's industrial lands" (*id.*, p. 191) and "to reflect the excess of Coast Line's industrial lands" (*id.*). In sum, Petitioner adheres to his position that the *Seaboard* decision, as well as the other precedents of both this Court and the Commission, supports the contention that the Commission has consistently taken ownership of industrial land values into consideration in rail merger proceedings.⁴ See *e.g.*, *Northern Lines Merger Cases*, 396 U.S. 491, 516-522; *New Haven Inclusion Cases*, 399 U.S. 392.

In any event, *Seaboard* involved an exchange of stock and the shareholders in the old companies continued to participate in the earnings of the merged enterprise. Here the WP shareholders are being eliminated. Thus this transaction is the equivalent of a liquidation of WP's physical assets whereby the shareholders are receiving \$209 million less than the current value of such assets. It is readily apparent, therefore, that the shareholders have not received compensation that is the economic equivalent of the current worth of the assets they are contributing.

The Federal Respondents (Br. p. 18, n.21) further misconstrue Petitioner's arguments by claiming that he is asserting "the Commission cannot change the methodology used to ascertain going concern value." Such is not the case. Petitioner's argument is simply that the Commission may not disclaim the methodology it applied in finding the UP offer "fair" with the bald statement that "[w]e do not prescribe this analytical approach for general use in evaluating the fairness of terms to shareholders" without identifying or explaining the under-

⁴ Petitioner is not contending that the Commission has not utilized the capitalized earnings approach in the past as UP seemingly implies. Rather, as supported by the Commission's *Seaboard* decision, Petitioner is contending that the Commission's adamant refusal to make appropriate adjustments in that formula in order to reflect the significant value of WP's industrial lands is a marked departure from past Commission merger cases.

lying reasons or facts which caused the Commission to use it herein.

The Federal Respondents (Br. p. 19, n. 23) also contend that Petitioner has misunderstood the Commission's construction of its "merger premium analysis." If such is the case, the Commission must share the blame. As the lower court observed (Pet. App. p. 37a) "the Commission's discussion of this issue is unduly condensed." The basic problem, however, is that the Commission's merger premium analysis was unnecessary. As previously noted (84-633 Pet. p. 14, n. 10), the WP's projected net income which is the foundation of the ICC's capitalization of earnings computations, already reflected the allocation of merger benefits. Hence, by removing the so-called "premium," the Commission has unreasonably stripped WP's shareholders of a portion of the value which they contributed to the merger through the realization of increased earnings.

C. The Value of WP's Industrial Land Holdings Was Not Taken Into Account in Setting the Negotiated Price

In their Brief in Opposition, Federal Respondents, but not UP, claim (Br. p. 18) that "[t]he value of WP's land holdings also was taken into account in setting the negotiated price of twenty dollars per share." This statement is absolutely false.

There is nothing of record to suggest that any of the parties to the negotiations were aware of the current appraised value of the WP's industrial lands on January 18, 1980, when the price of the WP shares was negotiated.⁵ When Mr. Flannery, the Chairman of the

⁵ Federal Respondents further misconstrue Petitioner's argument concerning the negotiations involving the amount to be paid for WP shares when they assert that Wheeler has contradicted himself "when he telescopes the several months of negotiations" to "but one afternoon." It is undisputed that the price to be paid for the WP shares was never discussed between the UP and WP representatives

Board and Chief Executive Officer of the WP, testified one year later, he was asked (Tr. p. 1474): "[w]hat is the fair market value of all of the real estate owned by Western Pacific and its subsidiaries?" He responded, "I wouldn't have any idea because the price of something like that depends on a willing buyer and a willing seller at the time you dispose of it." (*Id.*)⁶ He also testified that the WP's balance sheet would not have shown the fair market value. See Tr. 1476.

The Federal Respondents have not pointed to any evidence of record that would contradict Mr. Flannery's testimony or otherwise support their contention. Instead they allude to language in the Commission's report indicating that Salomon Brothers, in advising the WP's Board of Directors, had "considered all elements of value in the WP enterprise, including book value and net asset value" in determining a fair price.⁷ However, to the

until the afternoon of January 18, 1980. As Mr. Kenefick, the President and CEO and UP, testified (Tr. 980), his discussions with Mr. Flannery did not involve price until January 18. When asked to describe the substance of his discussions with Mr. Flannery, Mr. Kenefick responded (*id.*):

Basically, if he was interested in selling the railroad. And there were some discussions about the general conditions of maintenance and so on. The item of price, though, I can tell you was scrupulously avoided.

⁶ Mr. Flannery also admitted that, at that time, the WP had no appraisal of the fair market value of its San Francisco office building (Tr. 1474). In the subsequent Notice to Stockholders, released two years later, WP revealed that the building, which has a book value of \$536,000, had been the subject of various offers "of up to approximately \$6 million."

⁷ The ICC's description of the financial advisors' activities is subject to criticism. For example, according to the Commission's report (Pet. App. p. 301a) Salomon Brothers ascertained, among other things, the likely merger benefits as part of its fairness inquiry. But, as was conceded by the Salomon Brothers' witness during the course of cross-examination (Bifurcated Tr. 825-826, 834-835, 861), at the time the analysis was prepared, Salomon Brothers did not have any input from anyone concerning the benefits to be derived from the merger. As a result, they relied on

extent that the ICC determined that Salomon Brothers considered the net asset value of the industrial lands in its fairness opinion to the WP Board of Directors, the Commission is in error. The fairness opinion does not mention the real estate owned by WP. Furthermore, while Salomon Brothers had a general familiarity with WP's properties, the fairness opinion specifically states that Salomon Brothers "did not, in connection with our engagement, visit any of those properties, and have not undertaken an independent study to determine the valuation thereof."⁸ If Salomon Brothers placed any value on WP's non-operating real estate at all, it could only have been its book value which was the price paid many years before and did not reflect the present market value of those lands; a value approximating that of all WP's other assets (see 84-633 Pet. Cert. p. 7, n. 2). Obviously, the current fair market value of WP's real estate holdings was disregarded and not taken into account by the WP negotiators as Federal Respondents have erroneously asserted.⁹

"seat-of-the-pants guesstimates" (Br. Tr. 834) which were "assumed out of the air" (Br. Tr. 877).

⁸ "Independent" here means independent of the Company which, as Flannery testified, did not know the fair market value of its real estate. As a practical matter, it is inconceivable that a competent, reputable financial expert such as Salomon Brothers would have advised the WP Board of Directors that \$28 million would be a fair and reasonable price to accept for WP's industrial lands alone, much less the railroad, had they known that the lands were currently appraised in excess of \$137 million.

⁹ As previously noted, *supra*, p. 3 n. 2, it was only after the Commission's decision had been released that WP finally revealed the full extent of the current market value of its industrial lands. As a result, the Commission was not aware of the full value of the WP's industrial lands at the time it rendered its decision and could not have accounted for those holdings either directly or indirectly, as asserted by the Federal Respondents (Br. p. 17). By the same token, the value of WP's industrial lands could not have been reflected in the Commission's methodology, as Federal Respondents incorrectly claim (*id.*).

It should also be noted that there is nothing of record to indicate that UP, at the time the price was negotiated with WP, was aware of the current value of the California real estate owned by WP and not used for rail operations. In fact, Frederick M. R. Smith, UP's financial witness, testified (*Bifurcated Tr.*, p. 763) that he had not assigned a specific value to WP's non-transportation real estate and (*id.*, p. 765) that he did not know whether the value of WP's real estate was substantially greater than its book value.

In sum, the value of these lands was flatly ignored by UP, WP and finally by the Commission. As a result, the WP shareholders were not provided just and reasonable compensation for the true value of their contribution to UP. Given both the Commission's heavy reliance on the negotiations between Mr. Kenefick and Mr. Flannery (who subsequently was made President of UP) and the failure of the negotiators to know, let alone to consider, a major element of the value of WP, it follows that the Commission's finding that UP's offer was fair was arbitrary and capricious. Accordingly, this issue must be returned to the Commission for further consideration.

CONCLUSION

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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